



The Keynote Papers and the Current Financial Crisis

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1. The Keynote Papers and the Current Financial Crisis

One hesitates to write history as it happens, or to draw policy lessons from current events. The conference took place in May 2008 – after the government-assisted takeover of Bear Stearns but before a capital market downturn fueled a system-wide liquidity crisis, with successive insolvencies at IndyMac, Fannie Mae, Freddie Mac, Lehman, AIG, WaMu, and, as I write, Citigroup. But it would be odd to comment on capital market regulation without mentioning the events of the last three months. I am first to acknowledge that anything I might have written in May would not have foreseen the crisis or linked capital market regulation to financial institutions, which in the US have been conventionally treated as discrete in discourse and institutions (e.g., U.S. Treasury 2008; Leuz and Wysocki 2008).

Still, it is impossible not to review the keynote papers with the benefit of hindsight. The political/regulatory interventions to date, which include the largest bailouts in world history – and those that are certain to follow – underscore how eccentric it seems (now, today) for anyone to argue in favor of simply letting reputation, private lawsuits, and market reactions take their course, as Ball argues. Mahoney's suggestion – by implication, at least – that disclosure and free contracting are sufficient, has a giant new set of counterexamples to confront.¹ They may be sufficient for some purposes, but they surely now seem insufficient for several deep, systemic reasons. Stulz's paper has relevance in today's environment, with an economist's emphasis on trade-offs that make regulation more or less efficient under partly specified conditions, but its focus, too, is on disclosure – which was in place prior to the run-up in mortgage-related securities, yet seems not to have much helped to deter or mitigate the current crisis.

Pre-crisis disclosure rules or enforcement was no doubt imperfect – particularly regarding off-balance sheet accounting – and these imperfections contributed to the crisis. But many of the financial institutions currently in trouble made little or no use of off-balance sheet vehicles and simply misestimated the risks of their own assets. The collapse in trust and liquidity has been general. Pre-crisis efforts to subsidize home ownership, particularly but not exclusively among the poor, also contributed to the crisis. But the relaxation of credit standards that paved the way for the crisis were not limited to subprime – default rates for mortgage-related assets with no implicit government guarantee have also jumped. The collapse in housing values has been general. Neither imperfect disclosure rules nor unsound governmental housing policies can fairly be blamed for the extent of the current crisis.

Zingales's paper (at 8) was most prescient, noting: “While liquidity issues do not necessarily belong to the realm of security regulation, there are both historical and

¹ More generally, Mahoney's historical narrative omits the deregulatory fits that seize the SEC from time to time – integrated disclosure, Rule 144A, Regulation M -- and the fact that many of the “regulatory” aspects of the Sarbanes-Oxley Act (SOX) were imposed by the quasi-private stock exchanges that Mahoney 1997 has praised as a better locus for capital market regulation. See Coates 2001.

practical reasons to include them.”² But recent events cast a shadow over Zingales’s proposal to rely on a reinforced division of capital markets into a lightly regulated zone designed to give institutions free rein to innovate, on the one hand, and a heavily regulated zone designed to protect individuals from the depredations of intermediaries, on the other hand. The perception that securities law should reflect the potential effects of (il)liquid institutional capital markets did not in May 2008 suggest any clear need to intervene in the institutional market other than through ex post performance reporting. Much of what created the current crisis has nothing to do with direct depredations of individuals unable to compound interest. Rather, sophisticated institutions operating in the Rule 144A market — which Zingales would regulate more lightly — also went wildly wrong in risk assessments and investment decisions.

Events of late drive home how closely capital markets are integrated in the financial system. A bubble in one sector can have — has had — large and unpredicted spillover effects on everyone investing in *every* asset class through *every* type of intermediary. Money market and bond funds assets began to flee to banks and the U.S. government; interbank lending ceased; horrified near-retirees watched 401(k) accounts plunge by 40+%; the independent investment banking industry went the way of the dodo; and, in a minor but traditionally safe financial support sector near to my heart, 100+ year-old law firms were suddenly no more. Disclosure mandates failed to prevent speculative excess from crushing market actors too remote to exert meaningful control via contract or ex post litigation.

The crisis has left most observers — even those well cautioned against the Nirvana Fallacy — with a renewed respect for regulation of a more substantive nature. Such regulation includes deposit insurance, hurriedly adopted by a number of countries in a vivid illustration of game theory in action, and extended in the US to money market funds, large depositors, commercial paper, and conforming mortgages. Such regulation also includes capital rules and prudential supervision of financial institutions to address the moral hazard created by deposit insurance, implicit government guarantees, and the ad hoc bailouts that are the Bush administration’s contribution to if not socialism, then at least the history of socialism. Such regulation might also include subsidization and supervision of clearing facilities for important markets,³ such as the credit default swap market that brought down the world’s largest insurance company, which had been treated as so safe that counterparties had not demanded collateral even as its exposures increased — gambles that turned out to be good ones, given the bailouts. And such regulation might include control of agency and incentive problems afflicting gatekeepers such as rating agencies and mortgage brokers. At a minimum, the current crisis has called into question the adequacy of many taken-for-granted aspects of capital markets regulation not mentioned in the conference papers.⁴

² Cf. Leuz and Wysocki 2008 (surveying literature, finding little research on the aggregate economic and social effects of disclosure and reporting regulation).

³ www.sec.gov/news/testimony/2008/ts112008ers.htm

⁴ Prior to the crisis, some observers were arguing that public enforcement of securities laws had an important role. E.g., Jackson and Roe (forthcoming).

2. Distance Makes the Heart Grow Fonder?

What the keynote authors did all write about was “securities law,” but at different levels of abstraction, and there seems to be a positive relationship between the breadth of analysis and the enthusiasm of the evaluation. Zingales evaluates securities laws overall, and sees them in a positive light, if they are reshaped to segment investors by sophistication and wealth. Stulz studies mandatory disclosure across countries, and sees a role for disclosure mandates to reduce agency costs, even in an era of globalization, but only if the costs of private solutions remain high. Mahoney writes favorably of the broad sweep of securities laws of the 1930s, but regrets it has become less “contractual” and more “regulatory” in his lifetime, and implicitly critiques the effect of the specific, little-noticed change in litigation procedures that he argues created the boom in securities class actions, and the unexpected use of specific legal tools by prosecutors in the wake of Enron et al. Ball is most focused on one law – SOX. He contrasts “market” reactions, including reputational and market penalties but also civil and criminal enforcement under pre-existing laws, which he views as working reasonably well, with “political/regulatory” reactions – epitomized by SOX, which he critiques. I do not think there is an iron law of social science at work here: LaPorta et al. 2006 are implicitly critical of civil law countries’ approaches to securities regulation (particularly for being weak on disclosure and private enforcement) despite the authors’ highly abstract perspective; Prentice and Spence 2007, despite focusing carefully on the details of SOX, are favorable. Still, there may be a testable hypothesis for academic sociology at work here: the more distant one is from a law, the more likely, all else equal, one will praise it.

3. Disclosure Mandates Are Not Always “Soft” Law

A third theme of the keynote papers is to focus on disclosure regulation in preference to command-and-control regulation. Ball and Mahoney share the view that SOX was “regulatory” – different in kind from the conventional US securities laws. But they do not discuss the act in detail, so it is difficult to know precisely why they think this, perhaps because it is a view widely shared in the business press. SOX did have a significant impact: it created the PCAOB, which adopted rules that have contributed to a significant increase in expenditures on controls. But that increase is largely the result of the interaction of pre-existing liability risks with new *disclosure* obligations – the requirement that auditors “attest” to a company’s control disclosures – all in an effort to better implement long-standing securities laws (Coates 2007).⁵

To contrast “disclosure” under the 1933 and 1934 Acts with “regulation” in the Williams Act and SOX, as Mahoney does, reinforces the myth that mandates for disclosure (or, as in the UK, “comply or explain”) are always “soft” law. While disclosure requirements often are softer than command-and-control regulation, they can also create powerful incentives to act or refrain from acting (e.g., Roe 2003). Indeed, this is the case in Stulz’s model: disclosure laws assist private enforcement of optimal production decisions by corporate managers. In the presence of enforcement costs, agency costs, or collective

⁵ Other aspects of SOX are, relative to the effects of the attestation requirement, minor. Coates 2007.

action problems, a disclosure mandate can even be more effective than command-and-control regulation conditioned on difficult-to-observe facts, such as states of mind or judgmental cost/benefit trade-offs. Consider how much easier it was for Senator Ted Stevens to be convicted for failing to disclose gifts, as he was, than it would have been to convict him for accepting a bribe, which he wasn't — the latter requires difficult proof of an agreed-upon quid pro quo. The Foreign Corrupt Practices Act leverages the disclosure requirements under the securities laws to enforce bans on corruption and bribery. The most effective "regulatory" aspect of the Williams Act — the drastic reduction in profits that can accrue to a bidder who acquires a toehold in advance of a tender offer — derives from the disclosure mandate of Section 13(d), not the "regulatory" aspects of that law (e.g., Section 14(e)). In the case of both SOX and the Williams Act, moreover, it is plausible that lawmakers who adopted those laws did not anticipate the substantive changes that the disclosure requirements in those laws produced, which suggests the gap between stylized academic depictions of disclosure in theory and its real effects is of practical importance.

4. Law as a Consequence, Not Primarily a Cause, of Democratic Lawmaking

Another theme of the keynote papers is their introduction of politics into the evaluation of securities law. Ball indicts SOX as contributing to a "politicized" financial system.⁶ But this blames the flu on the fever — the flu (if that's what it is) being democracy, or a regulatory regime that responds to preferences of a democratic electorate. Ball points to the "Stigler (1964, 1971) — Peltzman (1976) skepticism for regulation," which (together with the public choice literature that preceded those articles) has long been part of the American voter's worldview (e.g., Hofstadter 1964). Nevertheless, US voters routinely elect governments that regulate. Indeed, if those models are even approximately right, how could it be otherwise, since they were predicated not on a credulous public but on rational apathy and variation in the costs of collection action? Regulation is an intermediate *output* of those models (on the way to rents for concentrated interests), and not the cause of the lawmaking system that creates it. "What survives from Stigler's 1971 article is an integration of the economics of regulation and the economics of politics in which transactions between self-interested suppliers and demanders determine the regulatory outcome" and in his "development of Stigler's theory [Peltzman 1976] showed that large economic shocks, such as the Great Depression, could produce unusual pressure for regulatory innovation" (Peltzman 1993).

As Peltzman 1993 notes, the patterns of regulation, deregulation and reregulation that have characterized the US over the last decades cannot easily be explained with the simple ingredients of Stigler and Peltzman's models. Nevertheless, they were clearly right that capital market regulation is in fact political; it can only be analyzed at least in part as the predictable response of democratically accountable government to financial crisis or scandal. In a democracy, it should no longer suffice to argue that the best regulation is none, when the joint lesson of history, economic theory, and our current

⁶ Ball states at [section 7 paragraph 1]: "the principal costs" of SOX are "the accelerated politicization of corporate governance and financial reporting."

situation is that crises and scandals recur regularly in any market-based system, however much or little regulated, and that when crises and scandals occur, a voter-investor body politic makes intervention highly likely, if not inevitable (Banner 1997; Coffee 2001). The distrust generated by crises and scandals “fuels support for government control over the economy ... even when people realize that the government is corrupt and ineffective” (Aghion et al. 2008, at 1). As Zingales notes (at 19): “A significant drop in the stock market has become a major public policy issue.” Because of “the enlarged importance of the stock market in the welfare of the average American,” “the political pressure to intervene” can be expected by market actors, and this “anticipation of this intervention creates a serious moral hazard problem, which can be limited only by some ex ante regulation.”

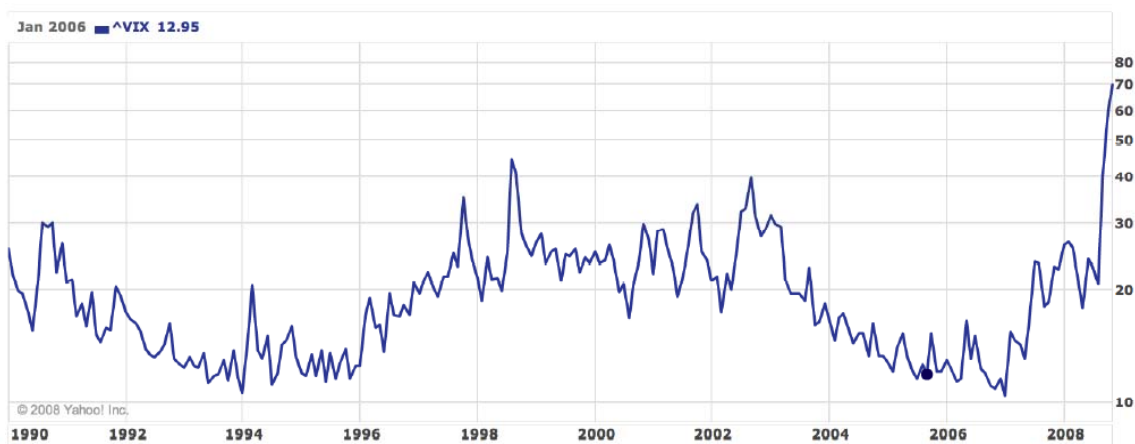
5. Potential Resources for Beneficial Political Shelter

The question, then, is how best to shape the regulation that follows, and particularly how to create or reinforce good forms of political shelter. That is, rather than criticizing particular instances of regulation, academics could more usefully attempt to theorize about how to design regulatory institutions that can respond and adapt in socially beneficial ways when political pressures to regulate periodically emerge, whether from Stigler-Peltzman style lobbying or from an uninformed but powerful investor-voter response to predictable market downturns.

Mahoney’s and Ball’s papers provide important insights into the two interlocking systems regulating the capital markets -- law and accounting. Mahoney argues that an apparently minor tweak in a set of rules (procedures for class actions) not directly related to securities arguably has had a larger long-term impact on securities law in practice than the content of anything in SOX – or anything deliberately adopted *as* securities law. The “private” securities class action – and the plaintiffs’ bar that exploits and protects it in the political sphere – is the most distinctive feature of the US legal system, when compared to its closest rival in the UK. Yet Mahoney’s history suggests it was never consciously designed or politically chosen. Supply can create demand; here, rules enabling securities class actions created their own lobby. One moral is familiar – the risk of unintended consequences – but it cautions as much about drives for deregulation and “smart” regulation as for regulation itself. But another aspect of Mahoney’s narrative – that it took many years for the securities class action to take off – also suggests a more affirmative potential lesson for regulatory design. If in the 1960s and 1970s, a forward-looking advocate for capital formation – which since 1996 Congress has required the SEC in part to be – had devoted some resources to monitoring developments in law and litigation it might have been able to intervene to moderate some of the less desirable results of securities class actions before they had produced a resistant political pressure group. Put more generally, regulatory bodies could not only be charged with overseeing conventional markets, but also examining legal and political markets through the Stigler-Peltzman lens.

Ball points to the 1969 case of *U.S. v. Simon*⁷ to argue that the true standard applicable to auditors is whether the audited financial statements “fairly present” an audit client’s financial position, and not whether the statements comply with the letter of GAAP. Ball is, I think, mistaken to argue that *Simon* represents the emergence of a common law standard from a “market” of private actors. The plaintiff in that case was the U.S. Department of Justice, and the auditor was convicted of violating the federal mail and wire fraud statute, not the common law tort of fraud. Nevertheless, his primary point is correct: long before SOX, auditors were, and continue to be, subject to a dense mesh of laws that provide them, and their clients, with incentives to provide true and complete disclosure to the capital markets, and those incentives have not been significantly eroded by decisions such as *Central Bank*,⁸ which substantially increased the difficulty for private plaintiffs to sue auditors for aiding and abetting fraud.

Indeed, risks to auditors may be at an all-time high. There is a clear historical correlation between litigation risk for the Big Four and stock market volatility (Talley 2006). Even if that correlation attenuates in the current anomalous environment, the fact that we are witnessing record levels of volatility (see Fig. 1, depicting the performance of the Chicago Board of Options Exchange Volatility Index). Thus, litigation risk is also likely high.



Do the spike in volatility and the likely increase in litigation risk make further regulation of auditors more or less likely to follow from the current crisis? Given the seemingly unavoidable need for some form of liability protection for auditors – and what else is that in economic terms but a bailout? – a system put into place by SOX (or something like it) would be the likely quid pro quo. Of course, the regulatory system might well have been better designed had lawmakers taken more time and not been pressured by voter reaction to Enron et al. The general point, again, is that when a bailout is likely to be needed (as a

⁷ 425 F.2d 796 (2d Cir. 1969).

⁸ 511 U.S. 164 (1994).

result of general political demand from voter-investors), the public (and industry) may be better served by well-designed regulation than the absence of regulation.

Both Ball's and Mahoney's papers also illustrate another general point about the relationship between laws and markets. Legal systems are to a degree autonomous – from politics as well as markets – in part because of their redundancy and complexity. Often this complexity is bemoaned – a favorite trope of business interests is to complain about legal uncertainty. But it turns out it has a benefit – it is one way that a legal system can protect against the democratic disease. By making changes in any one part of the legal system difficult to implement effectively without system-wide changes, a hypothetical social planner can raise the cost of legal change, and dampen the incentive for Stigler-Peltzman-style rent-seeking. Uncertainty provides political shelter. If there is anything to the claims of LaPorta et al. 2008 that some legal systems govern financial markets better than others, it may find a partial explanation here. In its very messiness and disorder, a legal system that divides lawmaking power and permits if not encourages law to be subject to continual challenge and contestation may deter the “grabbing hand” (Shleifer and Vishny 1998) more effectively than any anti-regulatory ideology could hope to do.

6. Conclusion

The phase of the crisis that began in September 2008 with Lehman's insolvency demonstrated how closely capital markets are integrated in the financial system, and that securities regulation cannot be considered apart from regulation of financial institutions. Disclosure, contract, and the threat of litigation failed to prevent misinvestment by large financial institutions from spilling over onto everyone else. Substantive financial regulation has been crucial to mitigating the downturn, and more regulation will almost certainly follow as a function of voter-investor political demand. As policymakers respond, they should recognize that moments of crisis create rare opportunities for regulatory design not achievable in ordinary times, when entrenched interest groups have greater sway. The keynote papers and the topics they address serve as reminders that disclosure mandates can have powerful and sometimes unintended substantive effects, that well-funded independent regulatory institutions may better resist future rent-seeking than weak regulators, and that legal uncertainty itself can create a form of shelter from rent-seeking pressures, with the implication that a degree of regulatory and legal redundancy and ambiguity be useful elements of a financial regulatory system.

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